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The Honorable Terry Goddard
Attorney General
State of Arizona
1276 West Washington
Phoenix, AZ 85007

Re: Renewable Energy Standard and Tariff Rules; Docket No. RE-00000C-05-0030; Decision No. 69127

Dear Attorney General Goddard:

I am writing to encourage you to certify the new Renewable Energy Standard and Tariff (REST) Rules approved by the Arizona Corporation Commission in Decision No. 69127. Because I feel that the passage of these rules is so important for the future of the state of Arizona, I am compelled to write you today to contradict the assertion that the Commission lacks the authority under the Arizona Constitution to enact the core provisions of the REST Rules.

Before beginning, I want to make clear that I respect the independence of your office and understand that your process for the evaluation of any rules package is based on a legal analysis and not a popular vote. This letter is in no way an attempt to interfere with your process or to instruct you in how to go about reviewing the REST Rules package. I am merely attempting to share with you my perspective on a matter to which I have devoted substantial time and thought.

As you are well aware, pursuant to A.R.S. § 41-1044(B), your office reviews the rules to ensure that, among other things, they are within the Commission's power to enact. Some have taken the position that the Commission lacks the constitutional authority to make and enforce the rules.

"The Commission's ratemaking authority granted by Article 15, Section 3, of the Arizona Constitution extends beyond setting rates to include the promulgation of rules and regulations that are 'reasonably necessary steps in ratemaking.'"[1] While opponents of the rules correctly state the law on this point,[2] the

[1] *Phelps Dodge Corp. v. Arizona Electric Power Co-op., Inc.*, 207 Ariz. 95, 111, 83 P.3d 573, 589 (App.2004), quoting *Arizona Corp. Comm'n v. State ex rel. Woods*, 171 Ariz. 286, 294, 830 p.2d 807, 815 (1992).

[2] Commissioner Gleason stated in his dissent at page 10 that "the courts have determined that the Commission has no regulatory authority under Article 15, Section 3 except that connected to its ratemaking power." This determination is less than clear. In *Woods*, the Arizona Supreme Court measured "the Commission's regulatory power by the doctrine apparently established by *Pacific Greyhound* and its progeny – that the Commission has no regulatory authority under Article 15, Section 3 except that connected to its ratemaking power." *Woods* at 294, 815. The court used the term "apparently" because the holding in *Pacific Greyhound* that "the legislature has the 'paramount power' to regulate in areas other than those concerned with ratemaking" is ambiguous. *Id.* at FN8. The *Woods* court decided that it "need not resolve this ambiguity at this time." *Id.* at 294, 815.

conclusion that the core provisions of the rules, R14-2-1804 (which requires utilities to satisfy an Annual Renewable Energy Requirement) and R14-2-1805 (which requires utilities to satisfy a Distributed Renewable Energy Requirement), are not reasonably necessary steps to ratemaking is incorrect.

The aforementioned rules are indeed reasonably necessary to ratemaking. This can be demonstrated by comparing the REST Rules to those rules in *Woods* that were found to be reasonably necessary to ratemaking and by contrasting them with those rules in *Phelps Dodge* that were struck down for lack of Commission authority.[3]

Similarity to *Woods*

In *Woods*, the Supreme Court of Arizona held that the Commission has the authority to promulgate its Affiliate Interest Rules under its constitutional ratemaking power. These rules required utilities to provide certain information to the Commission about the utility and its affiliates as well as to seek the Commission's approval prior to certain transactions. The court found that the Affiliate Interest Rules "arguably prevent utilities from endangering their assets through transactions with their affiliates. If such transactions damage a utility company's assets or net worth, the company will have to seek higher rates for survival. Thus, transactions with affiliated corporations could have a direct and devastating impact on rates."[4] The Affiliate Interest Rules were adopted by the Commission in response to the formation of holding companies by APS, the largest public utility in Arizona, and TEP. The court took notice that TEP nearly went bankrupt as a result of its reorganization and subsequent transactions with its affiliates. While TEP was able to obtain a dismissal of its creditors' petition under Chapter 11, it did so along with "a rate increase that it claimed was necessary to its financial survival."[5] The court also took notice that "the corporate conglomerate formed by Pinnacle West after the APS reorganization allegedly has faced serious financial difficulties, including financial problems of various affiliates and a threat by Pinnacle West to seek protection under Chapter 11 of the Bankruptcy Code."[6]

As a backdrop to the passage of the REST Rules, utilities' increasing dependence on fossil fuels, particularly natural gas, is already resulting in higher rates for consumers. In recent years, we have seen a series of rate cases by APS largely driven by rising fuel costs, primarily natural gas.[7] In each case, APS has claimed that these increases are necessary for its financial health and reiterate the importance of avoiding a credit downgrade which would add billions of dollars in interest costs that consumers would ultimately pay. Simple economics tells us that as the demand for a commodity increases, without a corresponding increase in supply, the price of that commodity will also increase. Sunlight (arguably the most plentiful natural resource in Arizona), geothermal energy, and wind are free. The proposed REST Rules will, over time, arguably decrease utilities' dependence on fossil fuels, insulating customers from volatile fuel costs which, if their prices continue on their present course, will have a direct and devastating impact on rates.

It has also been alleged that the REST Rules "impermissibly interfere with the management prerogative of the Affected Utilities."[8] That is not the case. The court in *Woods* found that the Affiliate Interest Rules

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[3] Although the rules I discuss were struck down after the court found that the Commission lacked constitutional and statutory authority, I am only addressing the issue of the Commission's constitutional authority.

[4] *Woods* at 294, 815.

[5] *Id.* at 290, 811, FN4.

[6] *Id.*

[7] Coal and nuclear are also important components of the generation mix, each with its own set of challenges. Coal fired generation faces increasing emissions restrictions necessary to combat global warming. Safety and performance are becoming issues for our nation's aging nuclear facilities, not to mention the issue of where to store the spent fuel.

[8] Decision No. 69127, Gleason Dissent at 11.

did not "so interfere with management functions that they constitute an attempt to control the corporation rather than an attempt to control rates."[9] Noting the "strong potential that transactions between affiliates will affect rates"[10] the court recognized "the effect of corporate structures, and dealings within those structures, on utility rates"[11] and rejected the notion that such a conclusion would allow the ACC "to invade every management decision of utility companies under the guise of ratemaking."[12] By affirming the Commission's constitutional authority to promulgate the Affiliate Interest Rules, the court satisfactorily resolved the Commission's "concern that its regulatory authority over public utility companies would be weakened and bypassed by the establishment of holding companies."[13]

The utilities' growing use of natural gas, even as prices remain volatile and continue along an upward trajectory, also has the strong potential to affect rates. The court in *Woods* found, "It would subvert the intent of the framers to limit the Commission's ratemaking powers so that it could do no more than raise utility rates to cure the damage from inter-company transactions."[14] That finding is equally applicable here. Without the ability to exert some influence over a utility's generation choices *ex ante*, the Commission's regulatory authority over rates is weakened - forcing upon it a Hobson's choice of whether to exclude additional conventional generation from rate base, financially weakening the utility, or continuing to add into rate base the utilities' choice of fossil-fueled generation, pushing electric rates unreasonably higher with their escalating fuel costs. The REST Rules do not impermissibly invade management. They are an attempt to control rates, not the company. The Commission is not mandating the entire generation portfolio of the utilities. The companies are given wide latitude in what renewable resources they choose to use. The Distributed Generation requirement is necessary to promote the use of solar energy. Although solar photovoltaic systems currently have higher costs up front, sunlight is available at zero cost and is a virtually unlimited natural resource – the most abundant in Arizona where the sun shines an average 321 days a year.

The court in *Woods* found that the ACC "must certainly be given the power to prevent a public service corporation from engaging in transactions that will so adversely affect its financial position that the ratepayers will have to make good the losses, and it cannot do so in any common-sense manner absent the authority to approve or disapprove such transactions in advance. To put it simply, the Commission was given the power to lock the barn door before the horse escapes."[15] As the price of fossil fuels continue to rise, it has become apparent to the Commission that the horse is headed for the barn door and the REST Rules are absolutely necessary to prevent its escape.

Distinguished from *Phelps Dodge*

In *Phelps Dodge*, the Arizona Court of Appeals found that the Commission lacked authority under the Arizona Constitution[16] to promulgate certain rules contained in its Retail Electric Competition Rules. The court found R14-2-1611(A), which stated that market based rates were deemed to be just and reasonable, to be unconstitutional and that the Commission improperly delegated to the competitive marketplace its "duty to set just and reasonable rates that provide for the needs of all whose interests are involved, including public service corporations and the consuming public."[17] The court found that the rule

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[9] *Woods* at 296, 817.
[10] *Id.* at 296,817.
[11] *Id.* at 295, 816.
[12] *Id.* at 295-96, 816-817.
[13] *Id.* at 290, 811.
[14] *Id.* at 296, 817.
[15] *Id.* at 297, 818.
[16] As I stated *supra* at FN3, the court in *Phelps Dodge* also found that the Commission lacked statutory authority to promulgate these rules, and I am only addressing the issue of the Commission's constitutional authority.
[17] *Phelps Dodge* at 108, 586.

prevented the Commission from fully performing its duty to set just and reasonable rates in violation of Article 15, Section 3, which "not only empowers the Commission to set just and reasonable rates" but "requires it to do so."[18]

The REST Rules 1804 and 1805 do quite the opposite of R14-2-1611(A). A significant portion of rates is dependent on the price of natural gas, which is driven by market forces and passed on to customers. The decision by utilities to rely on more and more gas fired generation was shaped by the market and, based on the information available at the time, seemed prudent. However, rapidly rising fuel costs are now putting the squeeze on customers. R14-2-1611(A) abdicated Commission oversight to the market while R14-2-1804 and R14-2-1805 increase the Commission's oversight, requiring utilities to obtain an increasing amount of power from renewable sources with zero, or very low, fuel costs. Rule 1611(A) weakened the Commission's ratemaking authority while Rules 1804 and 1805 strengthen that authority. If the Commission does not exert its authority *ex ante* over the type of generation utilities choose to employ, then the Commission has abdicated a significant part of ratemaking to the market in violation of its constitutional duty.

The court in *Phelps Dodge* also found R14-2-1609(C)-(J), which directed utilities to create an independent scheduling administrator to oversee access to transmission services, to be not reasonably necessary to ratemaking; therefore, the Commission did not have the power to promulgate that rule under Art 15, Section 3. The court found that rule to be similar to those provisions found to be outside the Commission's ratemaking authority in *US West I*.[19]

The REST Rules 1804 and 1805 bear no similarity to R14-2-1609(C)-(J). In fact, nowhere in the REST Rules are utilities required to create an independent agency to administer any part of the program.

The court in *Phelps Dodge* also found that the Commission lacks constitutional authority to promulgate R14-2-1615(A), requiring divestiture of competitive generation assets and services, and (C), exempting electric distribution cooperatives from these requirements if they do not offer competitive services outside their service territories. The court found these rules to be aimed at controlling the utility rather than rates and stated that it failed to understand how requiring the divestiture of competitive generation affects rates.

Based on my recollection of the California electricity crisis in 2000 - 2001, it appears to me that divestiture indeed has an effect on rates, just not the intended effect. The objective of retail electric competition was to let competitive market forces drive down rates from those set for the utilities. That is certainly not what took place in the wake of forced divestiture in California. The REST Rules 1804 and 1805 are aimed at reducing the ratepayers' exposure to volatile market forces, such as the fluctuating costs of natural gas, by increasing the amount of energy obtained from generation with little or no fuel costs. Under the REST Rules package this will be done under the Commission's watchful eye[20] and not left to market forces alone.

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[18] *Id.* at 107, 585.

[19] *US West Communications, Inc. v. Arizona Corp. Comm'n*, 197 Ariz. 16, 3 P.3d 936 (App.1999) (deciding rules requiring local exchange carriers to provide equal access for customers to choose long-distance services and to enter interconnection arrangements with other telecommunications companies outside Commission's plenary authority).

[20] The REST Rules include provisions that will ensure that the Commission monitors how utilities comply with the Rules and what customers will have to pay. *See* R14-2-1808 (Tariff filings), R14-2-1812 (Compliance Reports), R14-2-1813 (Implementation Plans), R14-2-1815 (Enforcement and Penalties), and R14-2-1816 (Waiver Provisions).

I hope that you will take into account my argument that the passage of the core REST Rules falls under the Commission's plenary ratemaking authority under Article 15, Section 3 of the Arizona Constitution. I know that you will carefully consider all issues pertaining to the certification of these rules, and I appreciate the opportunity to comment on one aspect of the matters in dispute.

Sincerely,

William A. Mundell

William A. Mundell, Commissioner
Arizona Corporation Commission

cc: Chairman Hatch-Miller
Commissioner Gleason
Commissioner Mayes
Commissioner Wong
Brian McNeil, Executive Director, Arizona Corporation Commission
Chris Kempley, Chief Counsel, Legal Division
Ernest Johnson, Director, Utilities Division
Lyn Farmer, Chief Administrative Law Judge, Hearing Division
Heather Murphy, Public Information Officer
Parties of Record